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On Behalf of  
The National Association of Manufacturers

Before the  
Subcommittee on Domestic and International  
Monetary Policy, Trade, and Technology

of the

House Committee on Financial Services

Hearing On  
China's Exchange Rate Regime and Its Effects on the U.S. Economy

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Mr. Chairman and Members of the Subcommittee:

I am pleased to testify today on behalf of the National Association of Manufacturers (the NAM) regarding China's exchange rate regime and its effects on the U.S. economy.

The NAM represents 14,000 U.S. manufacturing companies, including 10,000 small and medium-sized firms. No other trade subject comes close to commanding the attention that China is getting from both large and small NAM member companies. China is simultaneously the greatest concern of many of our import-competing members and the fastest-growing global market for many larger companies that operate internationally.

The NAM seeks a positive and balanced trade relationship with China that reflects market forces as closely as possible. There is no question that the Chinese currency is seriously undervalued is having a major effect on U.S. bilateral trade and on the trade of other nations as well. The bilateral trade situation with China is already serious, but will reach critical proportions if not addressed soon. The problem is still manageable if quick action is taken, and the currency imbalance is at the heart of the problem.

At that same time, the currency situation and trade with China must be seen in their proper perspectives. While the undervalued Chinese yuan appears to be the single most important aspect in our growing bilateral trade imbalance, it is not the only factor. Growing concerns over China's shortcomings in implementing World Trade Organization (WTO) commitments and other factors are important factors in the imbalance as well. Additionally, China's undervalued currency has broader implications beyond the bilateral effects.

It is also important to recognize that while the rising trade imbalance with China is a growing factor affecting U.S. manufacturing production and employment, it is far from the only factor. Domestic costs, falling U.S. exports, dollar overvaluation with other currencies, structural factors, regulatory pressures, and other issues are also at work. China must not be a "scapegoat" and an excuse for not tackling the other problems. Nonetheless, the China currency situation is so important that it must be addressed.

## **MANUFACTURING: VITAL TO AMERICA**

I would like to begin my statement with a review of why manufacturing is vital to the U.S. economy. Since manufacturing only represents about 16 percent of the nation's output, who cares? Isn't the United States a post-manufacturing services economy? Who needs manufacturing? The answer in brief is that the United States economy would collapse without manufacturing, as would our national security and our role in the world. That is because manufacturing is really the foundation of our economy, both in terms of innovation and production and in terms of supporting the rest of the economy. For example, many individuals point out that only about 3 percent of the U.S. workforce is on the farm, but they manage to feed the nation and export to the rest of the world. But how did this agricultural productivity come to be? It is because of the tractors and combines and satellite systems and fertilizers and advanced seeds, etc. that came from the genius and productivity of the manufacturing sector.

Similarly, in services -- can you envision an airline without airplanes? Fast food outlets without griddles and freezers? Insurance companies or banks without computers? Certainly not. The manufacturing industry is truly the innovation industry, without which the rest of the economy could not prosper. Manufacturing performs over 60 percent of the nation's research and development. Additionally, it also underlies the technological ability of the United States to maintain its national security and its global leadership.

Manufacturing makes a disproportionately large contribution to productivity, more than twice the rate of the overall economy, and pays wages that are about 20 percent higher than in other sectors. But its most fundamental importance lies in the fact that a healthy manufacturing sector truly underlies the entire U.S. standard of living -- because it is the principal way by which the United States pays its way in the world.

Manufacturing accounts for over 80 percent of all U.S. exports of goods. America's farmers will export somewhat over \$50 billion this year, but America's manufacturers export almost that much *every month!* Even when services are included, manufacturing accounts for two-thirds of all U.S. exports of goods and services.

If the U.S. manufacturing sector were to become seriously impaired, what combination of farm products together with architectural, travel, insurance, engineering and other services could make up for the missing two-thirds of our exports represented by manufactures? The answer is “none.” What would happen instead is the dollar would collapse, falling precipitously -- not to the reasonable level of 1997, but far below it -- and with this collapse would come high U.S. inflation, a wrenching economic downturn and a collapse in the U.S. standard of living and the U.S. leadership role in the world. That, most basically, is why the United States cannot become a “nation of shopkeepers.”

## **THE MANUFACTURING RECESSION**

Manufacturing went into recession in 2000 and only now -- three years later -- is beginning to show signs of a turnaround. Shipments of manufactured goods have fallen an astonishing \$270 billion since 2000, and over 2.7 million American factory jobs have been lost -- roughly one in every six jobs. The U.S. economic slowdown is essentially a manufacturing recession. The rest of the economy, while not growing at its usual rate, has not felt the same pain. Manufacturing represents 14 percent of the American workforce, but has accounted for nearly 90 percent of all the job losses since total U.S. employment peaked in March 2001.

With the tax cuts that have been enacted, low interest rates, and appreciation of some major foreign currencies from their previously highly-undervalued positions, the stage is now set for a turnaround in manufacturing. However, despite recent promising signs that the manufacturing sector is recovering from its three-year long recession, U.S. manufacturers continue to struggle in the face of weak demand and the most intense global competition in history.

The cost of manufacturing in the United States is rising steadily due to a variety of factors, including increased costs related to energy, health care, litigation and government regulation. At the same time, global competition prevents manufacturers from raising prices to offset these costs. Notwithstanding significant increases in productivity, many manufacturers have found no alternative but to cut back production, relocate plants abroad or stop producing altogether.

The NAM Board of Directors just last week identified the four priority policy areas that demand prompt attention from government policy makers:

- Reducing the cost of producing in the U.S. by containing health care costs, enacting legal reforms, including asbestos litigation reform, ensuring adequate and affordable energy supplies, and reforming the regulatory process to more effectively assess costs and benefits and the impact on industry. This is the single most important problem, and the difficulties of its solution must not be allowed to preclude priority action.
- Leveling the international playing field by ensuring that our major trading partners, including China and other Asian nations, reduce trade barriers, comply with international trade rules and allow markets to determine exchange rates.

- Promoting innovation, investment and productivity through tax reforms that encourage investment and R&D, domestic and international tax rules that keep U.S. manufacturers competitive and promote inward investment, and strengthened government R&D programs.
- Ensuring an adequate supply of skilled workers through greater emphasis on technical education, including engineering and science; strengthened implementation of the Workforce Investment Act; expanded business-government partnerships; and a redirecting of federal programs to assist displaced workers.

Manufacturing is at risk because it has been taken for granted, and burdens and costs have been imposed on manufacturing that are now being reflected in falling unemployment and growing outsourcing. A recent study commissioned by the NAM's Council of Manufacturing Associations, *Securing America's Future: The Case for a Strong Manufacturing Base*, prepared by noted economist and former Council of Economic Advisors member Dr. Joel Popkin, is clear in its warning that, "if the U.S. manufacturing base continues to shrink at the present rate and the critical mass is lost, the manufacturing innovation process will shift to other global centers. If this happens, a decline in U.S. living standards in the future is virtually assured."

The NAM is very pleased with the rising level of awareness on the part of the Administration and the Congress. On September 15, Commerce Secretary Evans gave a major speech in Detroit announcing the launch of a new Administration initiative on manufacturing that includes many of the NAM's own recommendations. In addition, Members of Congress have shown more interest in manufacturing issues and proposed several positive resolutions that address concerns the NAM has raised, notably on China's undervalued currency.

## **TRADE**

In looking at why the manufacturing recession is so sharp and why the sector is behaving differently from the rest of the economy and why recovery is so slow, trade immediately stands out as a huge factor. Of the \$270 billion drop in U.S. manufactured goods shipments since 2000 (through July 2003, at an annualized rate), \$80 billion stems from a drop in U.S. manufactured goods exports -- accounting for roughly one-third of the fall in production. A one percent increase in import penetration of manufactured goods over that time accounted for a further \$40 billion of the production decline -- about 15 percent. All of the increase in import penetration came from China. Import penetration from the rest of the world has been flat since 2000 -- meaning U.S. imports from them grew no faster than U.S. consumption.

Thus, in total, trade may have accounted for about half of the drop in production. That is why we will not see a robust economic recovery without a significant turnaround in net exports of manufactures.

Since 1997 the U.S. merchandise trade balance has gone from a deficit of \$180 billion to an annual rate of \$530 billion so far this year -- an increase of about \$350 billion. The fundamental cause has been the extreme run-up in the value of the U.S. dollar since 1997. At its peak the dollar rose about 25 percent over its early 1997 level according to the Federal Reserve Board's (FRB) trade-weighted broad currency index. Using the Institute for International Economics' rule of thumb that each one percent change in the value of the dollar leads to a \$10 billion shift in the trade balance, the appreciation of the dollar could account for about \$250 billion of the \$350 billion increase in the deficit -- or about 70 percent.

This is why the NAM worked hard to obtain a dollar policy based on market-determined exchange rates reflecting economic fundamentals. The Administration began enunciating such a policy last year. More recently, Treasury Secretary Snow has been very definite in his statements that markets must set currency values free of intervention. He has succeeded in achieving G-7 agreement, as reflected in their forceful support for market-determined currencies in the communiqué from their September 2003 meeting.

With the Administration's insistence that currency values should be determined by market forces, major currencies have been adjusting for over a year now. The euro is at \$1.15 today, compared to its low of \$0.87 in February 2002. (Today's level, however, is still below the euro's value throughout the 1990's, which -- using a constructed euro -- was \$1.21). The FRB index of industrial nation currencies peaked in February 2002 at 30 percent above its early 1997 level, but today stands only 8 percent above that level -- a welcome development that will help trade move toward greater equilibrium. However, the FRB's broad index of currencies, which includes most Asian currencies, peaked at 25 percent above its early 1997 level, and today still stands at 15 percent above that level.

Thus, despite widespread press statements about a "weak dollar", the dollar is still excessively strong. In fact, by the FRB's broad currency index, the dollar is stronger today than when former Treasury Secretary Rubin (architect of the "strong dollar policy") left office! The dollar was too strong then, and is even stronger now. The reason why the dollar is still so strong is that Asian countries have been preventing their currencies from reflecting market forces. The Chinese currency stands out, still being pegged at its devalued level of a decade ago; but other Asian governments have been intervening as well -- the Japanese government openly, and others less so.

Together, four Asian economies -- China, Japan, South Korea, and Taiwan -- hold \$1.2 trillion of official reserves, up \$600 billion in the last four years and up \$250 billion in just the last 12 months as they have purchased dollars to prevent an excess supply of dollars from lowering the value of their currencies. It should be pointed out that these four countries account for 60 percent of the entire global U.S. trade deficit in manufactured goods. All the rest of the world accounts for only 40 percent.

## **CHINA'S CURRENCY**

Turning to the Chinese currency, China is accumulating dollar reserves faster than any other country, including Japan. China's reserves at the end of August 2000 stood at \$365 billion dollars -- 120 percent of China's annual exports and nearly one-third of China's \$1.23 trillion GDP. China has added \$110 billion to its dollar reserves in just the last 12 months -- the largest increase in the world.

China devalued its currency by about 30 percent in 1994 and has maintained that value for the last nine years -- despite a huge increase in production capability, productivity, quality, production range, foreign direct investment inflows, and other factors that would normally be expected to cause a currency to appreciate. The currency is controlled by the government, and there is no marketplace for the yuan. The degree of upward pressure that the yuan would feel, however, is amply indicated in the amount of reserves that the Chinese government has to accumulate to maintain its artificial peg.

There are many estimates of where the currency would move if it were able to float -- i.e., what its market value would be. The NAM commends the work of Dr. Ernest Preeg, of the Manufacturers Alliance, as well as that of the Institute for International Economics' Dr. Morris Goldstein, who is testifying today -- as well as other estimates. Most estimates indicate an undervaluation between 15 and 40 percent. Given the price pressures expressed by many NAM member companies, I tend to believe the market price would be toward the upper end of that range.

The Chinese currency is the key, not just because of the huge bilateral imbalance, but also because other Asian countries are all looking over their shoulders at Chinese competition and are reluctant to allow their currencies to move up against China's. Once China's currency appreciates, though, they will be less reluctant to allow theirs to move upward as well.

## **EFFECTS OF UNDERVALUATION**

The U.S. trade deficit with China is now the largest in the world, standing at \$103 billion last year. China now accounts for more than one-fourth of America's total deficit in manufactured goods trade. As noted earlier, since 2000 the increase in China's import penetration of the U.S. market for manufactured goods represented about 15 percent of the decline in U.S. production. An estimate of the effect on employment is difficult to make and was beyond that which could be undertaken for this testimony.

The important thing is that the trade situation with China is still manageable, if addressed now. While information from our member companies makes it plain that industries such as plastics, machine tools, hardware, furniture, tool and die and others are feeling strong pressures from China now, the situation will become considerably more serious unless corrective steps are taken.

Imports from China last year were \$125 billion, while exports to China were \$22 billion -- meaning that imports are six times as large as exports, which makes correction of the bilateral deficit extremely difficult. Exhibit 1, attached to my statement, shows alternative U.S. trade balances with China in five years under various import and export growth rates. A continuation of the existing trends would result in a tripling of the trade deficit, to more than \$330 billion. There is no question that such a level would result in enormous calls for wide-spread protection. This must be headed off while there is time.

One good development is already apparent. U.S. exports to China have broken their long-term trend and are now growing about 25 percent a year. I believe this reflects the fact that China's market is beginning to open as a result of its entry into the World Trade Organization. Unfortunately, as the matrix in Exhibit 1 makes clear, no feasible sustained rate of export growth to China can slow the growth of the deficit, precisely because imports are six times as large as exports. Even a 33 percent annual rate of export growth would see the deficit grow two and a half times, to \$250 billion.

Thus if the deficit is to grow more moderately or fall, the rate of import growth must decline from the rates we have seen. The question, though, is how import growth rates can be moderated without resorting to protectionism. Protectionism must be avoided. We cannot reverse the open trading system that has been such a source of growth for the United States and the rest of the world and risk a downward cycle of trade deterioration. The answer, therefore is that we must rely on market mechanisms -- very importantly, including market-driven currencies.

Would a considerably stronger Chinese yuan have beneficial effects? Many of our member companies tell us that a 20 percent or more price shift would change the competitive situation dramatically. Others say their problems go beyond that. Some commentators state that Chinese wages are so low that no amount of appreciation would make a difference. Labor costs, however, are only one factor in the production process. In fact, production worker wages and benefits are only 11 percent of the cost of U.S. manufactured goods, on average. An exchange rate reflecting market forces would shift the competitive equation so that some Chinese industries would remain extremely competitive, while others would find their artificial advantage diluted. U.S. exports would also grow more rapidly, helping to bring about a more sustainable trade position.

The situation is not uniform, though. Some NAM member companies tell us that Chinese products are being offered for sale in the U.S. market at less than the cost of raw material inputs. These situations raise other questions, for even low labor costs and an undervalued currency could not account for this.

Additionally, it is important to recognize that not all of China's rapid export growth to the U.S. market necessarily competes with U.S. production. For example, Japan's share of U.S. imports has fallen as China's has risen -- implying the possibility of considerable substitution of Chinese for Japanese goods. China is now the largest supplier of computers and related components into the U.S. market. Yet in 2000, China was only our 5th-largest supplier. Though total U.S. imports of computers and components fell from 2000 to 2002, imports from China soared nearly 50 percent, while imports of these products from Japan fell 50 percent and from Korea fell over 40 percent.

A more market-oriented currency would benefit China as well as the United States. China's terms of trade and living standard would improve, and investment would tend to gravitate more toward domestic-led growth rather than exports. Additionally, the huge amounts of excess dollars that China must mop up every month are pouring too many yuan into the domestic economy, for one thing. Asset prices in China are beginning to reflect this factor. The International Monetary Fund's (IMF) recent international economic report makes it plain that currency reserve buildups by Asian nations are destabilizing to the world economy and need to be addressed.

The Administration has recognized the importance of having a Chinese currency that reflects market forces, and the NAM applauds the statements by the President and the work that Treasury Secretary Snow has been doing to obtain progress in this direction. The Secretary's discussions with the Chinese, the attention to the issue that he obtained in the recent Asia Pacific Economic Cooperation (APEC) Financial Ministers meeting, and particularly the agreement he obtained among G-7 Financial Ministers are vitally important. We hope the President will also put this issue front and center when he attends the APEC leaders' meeting later this month and meets with the leadership of the Chinese government.

The NAM believes the U.S. government must have all the leverage possible to resolve the issue quickly, and to this end has announced its support for the Coalition for a Sound Dollar's initiative to bring a trade impairment case against the Chinese currency under Section 301 of the Trade Act of 1974. Section 301 is the principal U.S. statute for addressing foreign unfair practices affecting U.S. trade, and is applicable in responding to "unreasonable, unjustifiable, or discriminatory foreign government practices that burden or restrict U.S. commerce." We believe China's currency practices fall within this scope.

China's action in sustained one-way purchases of dollars to maintain its peg are inconsistent both with its obligations in the IMF to avoid currency action for purposes of gaining a trade advantage, as well as with its obligations in the WTO to avoid frustrating trade liberalization through exchange rate action and to avoid subsidization of exports or impairment of trade benefits.

## **CHINA AS A MARKET**

Let me stress that we are seeking a market-oriented approach to U.S. - China trade. The U.S. - China trade relationship needs to be among the largest and strongest in the world, and needs to proceed in a way that clearly benefits both countries. It is also very important to avoid viewing China in a one-sided manner. In addition to being a rapidly rising supplier of imports into the U.S. market, China is also a quickly growing market for foreign goods and services, and this must not be overlooked. Last year China was our fastest-growing export market. While our overall exports fell 5 percent, our exports to China were up 15 percent. Last year China was the second-largest market for U.S. commercial jet aircraft. China has the same potential for many products.



There is enormous potential for expansion. Less than 10 percent of China's imports come from the United States. The European Union, for example, sells 30 percent more to China than we do. We need to examine why the U.S. has only 8 percent of China's import market, and what -- in addition to a currency shift -- U.S. exporters need to do to change this situation and help boost two-way trade.

It is also important to contemplate the significance of the fact that China's trade with the rest of the world as a whole is in deficit. In 2002, using U.S. data, China's surplus with us was \$103 billion. China's global trade surplus was \$30 billion, implying a \$73 billion deficit with the rest of the world. Much of this is imports of oil and other commodities, and large amounts are also comprised of electronic components that China purchases from other Asian countries to assemble into final products for export to the United States.

## **A POSITIVE AGENDA**

We need a positive agenda in addressing China. In building this relationship, we need a combination of steps to ensure that trade follows market principles, and to ensure that U.S. productivity and technology continues to provide us a competitive edge in a productive and more balanced relationship. The first step has already been taken: getting China into the WTO so it will follow global trade rules. In the NAM's view, we now need to pursue a set of steps to ensure more market-driven trade between China and the United States. This would include:

1. **Seek full WTO Compliance.** We must ensure that China complies with its commitments as a new World Trade Organization member to follow all international trade rules and open its internal market in accordance with specific benchmarks set forth in its membership agreement. The NAM has established a WTO compliance monitoring program of its own and submitted its second annual compliance report based on member input to the U.S. Trade Representative (USTR) on Sept. 10. We have also pressed for more Commerce and USTR resources for monitoring and investigating compliance problems.
2. **Stop Currency Undervaluation.** We must press China to end the manipulation of its currency and allow the yuan/dollar exchange rate to be determined by the market. China needs to move toward a market-determined currency as quickly as possible, revaluing its currency significantly in the interim.
3. **End Subsidized and Non-Market Production.** We must ensure that the development of Chinese industry follows market principles and does not benefit from direct or indirect subsidies that distort trade flows.
4. **Address Counterfeiting and IPR Violations.** We must take firm actions to end China's rampant counterfeiting of U.S. and other products. Today, China is the epicenter of world counterfeiting, costing us tens of billions of dollars in lost exports and the related jobs.

5. **Expand Export Promotion to Support U.S. Business.** Finally, we must undertake a massive joint public-private export trade effort to increase U.S. exports to China. In 2003, China is set to become the world's 3<sup>rd</sup> largest importer (\$380 billion) but the United States only has an 8 percent share of all Chinese imports. U.S. companies need to increase their marketing efforts but greatly expanded Commerce Department and other promotion assistance is also needed.

## CONCLUSION

I want to conclude by reiterating that we will not succeed in preventing the migration of our manufacturing base to China and other foreign countries if we do not address the high cost of manufacturing in the United States and get the U.S. economy moving again. A fairly valued Chinese currency is important, but we must not forget that the bulk of our problems are home-grown.

U.S. industry is burdened by legal and regulatory systems that retard growth and destroy jobs. Unrestrained asbestos liability alone, for example, could cost U.S. industry \$250 billion, resulting in the bankruptcy of even large corporations. Rapidly rising health care costs are a constant worry, particularly for small manufacturers. Uncertainty over sources of energy supply has led to price volatility. Lack of support for research and development threatens to undermine U.S. technology leadership. And shortages of skilled workers have many manufacturers wondering how they can expand in the future. .

Additionally, bilateral, regional and WTO trade agreements must be negotiated as quickly as possible to get foreign trade barriers eliminated, or at least down to our own low level. U.S. tariffs on manufactured goods average less than 2 percent, while in many parts of the world U.S.-made goods face tariffs 10-15 times higher -- or even more.

Unless these challenges are also addressed, we can expect a significant further erosion in the U.S. industrial base. Competition with China will only accelerate the trend. However, if we begin to act now, with both a refocused and positive trade policy toward China and a concerted strategy on economic growth and manufacturing renewal, we can restore the dynamism and competitiveness of U.S. industry and ensure the global leadership that is so central to our economic and national security.

Thank you, Mr. Chairman.

**EXHIBIT 1**

**ALTERNATIVE U.S. TRADE DEFICITS WITH CHINA**

**20-Year Trend: Exports to China up 12% per year;  
Imports up 20% per year**

**IF THESE TRENDS CONTINUE FOR 5 MORE YEARS  
THE CHINA TRADE DEFICIT WILL TRIPLE, TO \$330 BILLION**

Projected 2008 Trade Deficits with China  
Under Alternative Export and Import Growth Rates  
(Billions of Dollars)

Import% \ Export%			
	12%	25%	33%
20%	(\$330)	(\$290)	(\$252)
15%	(\$246)	(\$205)	(\$167)
10%	(\$178)	(\$138)	(\$100)
7%	(\$144)	(\$104)	(\$66)

**NATIONAL ASSOCIATION OF MANUFACTURERS**